Chicago-Kent Law Review

Volume 87
Issue 3 *The Future of the Establishment Clause In Context: Neutrality, Religion, or Avoidance?*

Article 10

June 2012

Hide That Syndicated Junk in the Closet! A Case for Credit Risk Retention in the CLO Market

Adam Altman

HIDE THAT SYNDICATED JUNK IN THE CLOSET! A CASE FOR CREDIT RISK RETENTION IN THE CLO MARKET

ADAM ALTMAN*

INTRODUCTION: THE FALL OF AN ICON

The *Chicago Tribune*, founded in 1847, is the most widely distributed daily newspaper in the Great Lakes region.[1] The newspaper that once proclaimed itself the "World's Greatest Newspaper," is famous for its quality reporting from a highly accomplished staff, which, over the years has included legendary columnists such as Gene Siskel, Mike Royko, and Bob Greene.[2] The *Chicago Tribune's* November 3, 1948 front-page was, perhaps, its most famous. The headline, "DEWEY DEFEATS TRUMAN," was misleading.[3] But, the photograph of President Truman smiling exuberantly while holding up a copy of the *Tribune* became an American icon.

In contrast to the lighthearted effects of the erroneous headline from 1948, the *Chicago Tribune's* front page on December 9, 2008 included a story that would have much greater potential consequences for the venerable newspaper. Michael Oneal and Phil Rosenthal wrote the headline story, "Tribune Co. Files for Chapter 11."[4] The *Chicago Tribune's* parent company, which also owned the *Los Angeles Times*, WGN America, and the Chicago Cubs, was bankrupt.[5]

Just one year earlier, real estate mogul and billionaire, Sam Zell, purchased the Tribune Company for $8.2 billion.[6] Mr. Zell financed the purchase primarily through debt instruments known as syndicated bank loans.[7]

---

* J.D. Candidate, Chicago-Kent College of Law, December 2012; CDO Analyst, U.S. Bank. This Note is dedicated to my wife Emily. She always believes in me, and she pushed me to write when I was not sure I could. I love you Emily. Thank you also to my Grandma, Tootie Hecht, she encouragingly kept asking me when I was going to law school.

1. *Circulation averages for the six months ended: 3/31/2011*, AUDIT BUREAU OF CIRCULATIONS, http://abcas3.accessabc.com/ecirc/newstitlesearchus.asp (last visited Nov. 13, 2011).

2. JAMES O'SHEA, THE DEAL FROM HELL: HOW MOGULS AND WALL STREET PLUNDERED GREAT AMERICAN NEWSPAPERS 36, 148 (1st ed. 2011); *Gene Siskel died 10 years ago today*, CHI. TRIB., Feb. 20, 2009.

3. *Dewey Defeats Truman*, CHI. TRIB., Nov. 3, 1948, at 1.

4. Michael Oneal & Phil Rosenthal, *Tribune Co. files for Chapter 11*, CHI. TRIB., Dec. 9, 2008, at 1.

5. *Id.*

6. David Carr, *At Flagging Tribune, Tales of a Bankrupt Culture*, N.Y. TIMES, Oct. 5, 2010, at 1.

7. *Id.*

This crushing debt burden combined with a decline in the overall media industry and a struggling national economy, led to what Mr. Zell described as the "perfect storm" for the Tribune Company.[8] Ultimately, the Tribune Company defaulted on more than $10 billion of syndicated bank loans.[9] It was the largest default in the history of the syndicated bank loan market.[10]

Syndicated loans, like the ones that the Tribune Company issued in 2007, are a contentious issue within the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[11] Various industry participants including banks, hedge funds, and law firms, argue that securitizations of syndicated bank loans should be excluded from the Dodd-Frank risk retention requirements.[12] This note focuses on the imprecise and possibly inaccurate assumptions upon which these arguments rely. Part one introduces syndicated loans and collateralized loan obligations ("CLOs"). In addition, part one highlights the risk retention provisions of the Dodd-Frank Act that apply to CLOs and syndicated bank loans. Part two of this note examines the plain language and the legislative intent of the relevant section of the Dodd-Frank Act. Finally, part three of this note suggests that CLOs and syndicated bank loans should not be excluded from the Dodd-Frank risk retention requirements.

I. THE PRIMROSE PATH TO THE CLO MARKET

Some critics of the Dodd-Frank risk retention mandate argue that Congress should have been more lenient in providing exceptions and exemptions from the rule.[13] Specifically, they argue that CLOs consisting of syndicated bank loans should not be subject to the risk retention provi-

8. Oneal & Rosenthal, *supra* note 4, at 1.

9. *Syndicated Bank Loans: 2008 Default Review and 2009 Outlook*, MOODY'S CREDIT POLICY 2 (Mar. 2009); *see also* Sharon Ou & Kenneth Emery, *Corporate Default and Recovery Rates, 1920 – 2008*, MOODY'S GLOBAL CREDIT POLICY 19 (Feb. 2009).

10. *Syndicated Bank Loans*, *supra* note 9, at 2 (explaining that Tribune Company was the largest syndicated loan default between 1996 and 2008. n 2009, Lyondell Chemical eclipsed this when it defaulted on more than $18.8 billion of loans).

11. *Compare* Bram Smith, Comment on *Notice of Proposed Rulemaking, Credit Risk Retention*, THE LOAN SYNDICATION AND TRADING ASS'N (Aug. 1, 2011), http://www.lsta.org/WorkArea/showcontent.aspx?id=13958 [hereinafter LSTA Comment Letter] (arguing that risk retention should not apply to open market CLO managers), *with* Credit Risk Retention, 76 Fed. Reg. 24090 (proposed Mar. 28, 2011) [hereinafter Notice of Proposed Rules] (proposing risk retention rules for all classes of securitizations).

12. *See* LSTA Comment Letter, *supra* note 11; *see also Impact of Dodd-Frank's Risk Retention Rules on CLOs: Regulatory Agencies' Failure to Account for Crucial Differences among Asset Classes has Potential to Stunt CLO Market, Causing Real Harm to Commercial Lending Markets*, MORRISON FOERSTER 4 (May 25, 2011), http://www.mofo.com/files/Uploads/Images/110525-Impact-of-Dodd-Franks-Risk-Retention-Rules-on-CLOs.pdf.

13. LSTA Comment Letter, *supra* note 11, at 17.

sions.[14] The first step in evaluating these arguments is to understand both syndicated bank loans and CLOs. Moreover, some background on the pertinent section of the Dodd-Frank Act will illustrate its applicability to the CLO market.

A. Syndicated Bank Loans

Syndicated bank loans originated in the 1980s, and they have since become a popular method by which corporations raise capital.[15] By 2010, syndicated loan commitments in the United States alone reached $2.5 trillion.[16] In contrast to bilateral bank loans between one bank and one borrower, syndicated bank loans involve multiple banks or investors who commit to lending to the corporate borrower.[17] Typically, a large bank leads or arranges the syndicate of lenders.[18] Some syndicated loans, such as the ones that the Tribune Company issued, can involve billions of dollars and dozens of lenders.[19] This loan structure allows the borrower to raise more money than it could from a single lender. At the same time, the process requires the borrower to maintain contact with only the arranger.[20] Therefore, the borrower can raise all of the capital that it needs without the extensive administrative costs that it would incur if it had to borrow through many smaller loans from numerous individual lenders.

1. Differences Between Syndicated Bank Loans and Corporate Bonds

In addition to the distinction between syndicated and bilateral loans, syndicated bank loans also differ significantly from corporate bonds. Whereas syndicated bank loans are usually private transactions amongst corporate borrowers and their lenders, corporate bonds are usually available to the investing public at large. Some corporate bonds are even traded on the New York Stock Exchange.[21] In 2011, market participants traded

14. *See generally* LSTA Comment Letter, *supra* note 11.

15. William Chew & Steven Miller, STANDARD & POOR'S , A GUIDE TO THE LOAN MARKET 7 (Sept. 2011) [hereinafter S&P GUIDE], https://www.lcdcomps.com/d/pdf/LoanMarketguide.pdf.

16. *Credit Quality of the Shared National Credit Portfolio Improved in 2010*, FED. RESERVE BD. (Sept. 28, 2010), http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm.

17. FRANK J. FABOZZI ET AL., COLLATERALIZED DEBT OBLIGATIONS: STRUCTURES AND ANALYSIS 44 (2d ed. 2006).

18. *Id.* at 46.

19. Jonathan Stempel, *Tribune files bankruptcy plan, lenders cry "unfair,"* REUTERS (Apr. 12, 2010), http://www.reuters.com/article/2010/04/12/us-tribune-lenders-idUSTRE63B33X20100412.

20. *See* S&P GUIDE, *supra* note 15, at 7. While the syndication process can involve more than one arranger, the borrower usually deals with the lead arranger. Even when the borrower deals with multiple arrangers, it is still more efficient than dealing with each individual lender.

21. *Compare* LSTA Comment Letter, *supra* note 11, at 4–5 (explaining that syndicated lenders typically have a relationship with the borrowers), *with Corporate Bonds*, FIN. INDUS. REGULATORY

more than $400 billion worth of syndicated bank loans.[22] By contrast, the annual trading volume for corporate bonds is approximately $4 trillion, more than ten times the size of the secondary market for syndicated bank loans.[23]

Aside from the differences in market size and scope, syndicated loans differ from corporate bonds in a few other critical ways. First, syndicated loans are typically secured by a lien on the borrower's assets.[24] As a result, syndicated lenders have priority over the claims of all other types of creditors in the capital structure;[25] the borrower must repay the syndicated lender before paying any other lender or investor.[26] In addition, syndicated bank loans usually involve more covenants than corporate bonds.[27] Covenants give lenders some financial control over the borrower, which can mitigate the risks of default or other losses.[28] Some of the more common covenants include restrictions on the borrower's use of the loan proceeds, the borrower's capacity to issue additional debt instruments, and the borrower's ability to change its ownership.[29]

Another significant difference between corporate bonds and syndicated bank loans involves their rates of interest. Whereas corporate bonds are usually fixed-rate investments, syndicated bank loans are usually variable-rate investments.[30] Syndicated bank loans typically bear interest at a rate

---

AUTH., apps.finra.org/investor_information/smart/bonds/306000.asp (last visited Feb. 23, 2012) (explaining that corporate bonds trade in over-the-counter markets between bond dealers and brokers, and some trade on the NYSE).

22. LSTA Comment Letter, *supra* note 11, at 5 (quoting LSTA Trade and Settlement Study, Feb. 3, 2011).

23. *See Statistics,* SEC. INDUSTRY AND FIN. MARKETS ASS'N, http://www.sifma.org/research/statistics.aspx (download U.S. Bond Market Trading Volume) (last visited Feb. 23, 2012). The secondary market is the trading market in which buyers and sellers trade syndicated bank loans. By contrast, the primary market is where the initial investor buys a portion of a syndicated bank loan directly from the borrower or arranger. Through December 2011, the average daily trading volume for all publicly traded corporate bonds was $15.6 billion; 256 trading days per year multiplied by the average of $15.6 billion, yields an average annualized trading volume of $3.997 trillion.

24. Gary D. Chamblee & Jolie A. Tenholder, *Converging Markets: Leveraged Syndicated Loans and High-Yield Bonds*, COMMERCIAL LENDING REVIEW 7 (Nov.-Dec. 2005).

25. Peter J. Nigro et al., *Some Evidence On The Secondary Market Trading Of Syndicated Loans*, 8 J. OF BUS. & ECON. RES. 33, 35 (May 2010).

26. *Id.*

27. Glenn Yago & Donald McCarthy, *The U.S. Leveraged Loan Market: A Primer*, MILKEN INSTITUTE 5 (Oct. 2004), http://www.milkeninstitute.org/pdf/loan_primer_1004.pdf.

28. *Id.*

29. Chamblee & Tenholder, *supra* note 24, at 12.

30. Yago & McCarthy, *supra* note 27, at 5. For variable rate loans the applicable interest rate changes at specified intervals—usually monthly or quarterly—based on market conditions. For fixed rate debt instruments, the applicable interest rate remains constant throughout the life of the debt, regardless of market conditions.

equal to the London Interbank Offer Rate ("LIBOR")[31] plus an amount of interest known as the "spread."[32] The purpose of the spread is to compensate lenders for the credit risk associated with the particular borrower.[33] In other words, LIBOR is the reference or starting point, and the spread is the additional borrowing cost attributed to the riskiness of the borrower. For example, some of the syndicated loans that the Tribune Company issued in 2007 had an interest rate of LIBOR plus 3%, for a total rate of 5.52%.[34]

2. CLOs Play a Key Role in the Syndicated Bank Loan Market

The flexible characteristics of syndicated bank loans make them attractive to borrowers and lenders.[35] In addition, the growing secondary or trading market for syndicated loans gives lenders a viable way to exit the investment before maturity.[36] As a result of these factors, the syndicated bank loan market has grown dramatically; banks originated only $37 million worth of loans in 1987, but by 2004, that number was a staggering $1.2 trillion.[37] Moreover, new types of lenders have entered the market and helped to fuel the growth of the syndicated bank loan market. Although banks are imperative in facilitating these loans, they are no longer the primary source of capital for syndicated loans.[38]

While a large bank usually arranges the group of lenders for a syndicated bank loan, the remaining lenders are often other banks, finance companies, and institutional investors.[39] Institutional investors are groups of investors including hedge funds, pension funds, and CLOs.[40] Of these institutional investors, CLOs were, in 2007, the "dominant form of institutional investment" in the syndicated loan market, accounting for "60% of primary activity by institutional investors."[41]

---

31. BBA LIBOR, http://www.bbalibor.com/bbalibor-explained/the-basics (last visited Feb. 24, 2012). LIBOR is the rate at which banks in the London wholesale money market can borrow from each other; the rate at which an individual Contributor Panel bank could borrow funds, were it to do so by asking and then accepting inter-bank offers in reasonable market size, just prior to 11:00 am London time.

32. Yago & McCarthy, *supra* note 27, at 5.

33. *Id.*

34. Tribune Co., Credit Agreement (Form DEFA14A) 2 (May 17, 2007) (definition of "Applicable Margin").

35. Nigro et al., *supra* note 25, at 35.

36. *Id.* at 36.

37. *Id.* at 33.

38. Chew & Miller, *supra* note 15, at 10.

39. *Id.*

40. *Id.*

41. *Id.*

B. The ABCs of CLOs

Explaining why CLOs are such large investors in syndicated bank loans requires understanding some of the basics of CLOs. Collateralized loan obligations are pools of debt obligations; these pools often include syndicated bank loans, bilateral bank loans, and high yield corporate bonds.[42] CLOs are a type of collateralized debt obligation ("CDO").[43] Other types of CDOs such as collateralized insurance obligations ("CIOs") or commercial real estate obligations ("CRE CDOs"), are comprised of insurance contracts or commercial real estate assets. By contrast, CLOs hold high-yield corporate debt.[44] The manager of the CLO loan pool uses the principal and interest payments from the corporate loans as collateral to issue bonds to other institutional investors. The CLO manager is usually an asset manager, such as Prudential Investment Management, Oak Hill Advisors, or Pacific Investment Management.[45] The manager uses proceeds from the bond issuance to buy more corporate loans for the pool.[46] Through this structure, CLO bondholders gain exposure to a diversified pool of corporate debt, without having to expend the resources necessary to manage the loan pool. The CLO manager benefits by earning fees for managing the pool. Furthermore, some managers hold a portion of the CLO's equity[47]– the difference between the incoming payments from the loan pool and the outgoing payments on the bonds.

The CLO manager separates the bonds that it issues into different classes or tranches based on the risk characteristics of each bond.[48] Bonds with the first claim to the cash flow from the underlying pool are the least risky because they absorb losses from the underlying collateral pool only after all of the lower tranches absorb such losses.[49] Because they entail less

42. Andreas A. Jobst, *Collateralised Loan Obligations (CLOs): A Primer*, THE SECURITIZATION CONDUIT, 2003, at 8–9.

43. Presentation by Malick Sy, *CDOs Risk Management & All About CDOs*, ICO-OP.NET 17, http://www.ico-op.net/downloads/CDO%20Risk%20Management%20Slides.pdf (last visited Feb. 24, 2012). iCo-op.net is a business focused on solutions for governance, risk, management, and compliance; the source is a presentation on risk management for CDOs.

44. *Id.* at 18.

45. Karen Sibayan, *S&P to Step Up CLO Manager Monitoring*, LEVERAGED FIN. NEWS (Mar. 11, 2009), http://www.leveragedfinancenews.com/news/190992-1.html.

46. David L. Batty, *Dodd-Frank's Requirement of "Skin in the Game" for Asset-Backed Securities May Scalp Corporate Loan Liquidity*, 15 N.C. BANKING INST. 13, 19 (Mar. 2011).

47. BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 47 (Oct. 2010) [hereinafter FRB REPORT].

48. *See* Fabozzi et al., *supra* note 17, at 7 (discussing the structure of CDOs and CLOs).

49. Joshua Coval et al., *Re-Examining the Role of Rating Agencies: Lessons from Structured Finance* 9 (Jan. 2008) (unpublished manuscript) (http://www.people.hbs.edu/estafford/Papers/CJS_Ratings.pdf).

risk, these senior or first priority classes command a lower interest rate.[50] By contrast, holders of the most subordinated class of bonds receive the highest interest rates in exchange for the lowest priority claim to the underlying debt pool's cash flows.[51]

Between 1997 and 2007, new CLO issues grew from $51 million to $85.8 billion.[52] Numerous factors contributed to this tremendous growth in CLO issuance. In simple terms, however, the driving force behind the growth of the CLO market was its attractive risk and return profile.[53] During this time, many CLO bonds yielded higher interest rates than some corporate bonds.[54] At the same time, however, rating agencies and investors underestimated the default risks of highly leveraged debt instruments, like CLO bonds.[55] Therefore, relative to corporate bond investors, CLO bond investors thought they were earning more on their investments without taking any additional risk.

An investment that yields high returns in exchange for low risk is a conundrum.[56] During the phenomenal growth period for CLOs, however, investors began to expect this financial phenomenon.[57] A few interrelated factors stoked these expectations: portfolio diversification theory combined with advancements in credit risk modeling and investor reliance on rating agencies.

---

50. FABOZZI ET AL., *supra* note 17, at 7 (exhibit 1.3, showing the coupon for different classes of CLO bonds).

51. *Id.*

52. *Challenges Facing CLOs . . . and the Loan Market,* THE LOAN SYNDICATION AND TRADING ASS'N 5 (2009) [hereinafter LSTA White Paper], http://www.lsta.org/WorkArea/downloadasset.aspx?id=6170.

53. *See* Anna K. Barnett-Hart, *The Story of the CDO Market Meltdown: An Empirical Analysis* 7 (Mar. 19, 2009) (unpublished B.A. thesis, Harvard College) (http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf) (describing how the structural mechanics of CDOs allowed investors to receive higher returns on their investments, while at the same time not violating their risk limits).

54. Fabozzi, *supra* note 17, at 10 (exhibit 1.4).

55. S&P GUIDE, *supra* note 15, at 10 (explaining that CLOs issue debt that is as much as 10 to 11 times their equity); MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS 118 (1st ed. 2009) (noting that investors perceived CDOs as a "win-win proposition" because they offered measurable risks in exchange for relatively high returns).

56. *See* Harry Markowitz, *Portfolio Selection,* 7 J. FIN. 77 (1952) (explaining risk and return as a rule of finance: the "expected returns—variance of returns" rule; theory is based on the assumption that the rational investor will only take on more risk in exchange for higher expected returns).

57. *See* ZANDI, *supra* note 55, at 118, 123-125 (explaining that CDOs offered "precisely calibrate[d]" risk in exchange for high returns; also illustrating that "investing with leverage can be lethal," and some investors, like two of the Bear Stearns hedge funds, did not fully appreciate the risks of investing in leveraged CDOs).

1. Portfolio Theory and Credit Risk Modeling

An investor who owns a piece of a CLO that holds many different types of bank loans is theoretically taking less risk than if the investor merely owned a single bank loan. The theory that a diversified portfolio of assets is less risky than a non-diversified portfolio is not a recent development in finance and economics.[58] In 1952, Nobel laureate Harry Markowitz explained that "[a] portfolio with sixty different railway securities, for example, would not be as well diversified as the same size portfolio with some railroad, some public utility, mining, various sort[s] of manufacturing, etc."[59] CLO managers rely upon this theory of diversification when picking loans for underlying pools of collateral.[60] Therefore, the entire collateral pool is not susceptible to downturns in specific economic sectors.

Similar to diversifying amongst different industries, the CLO's governing documents typically specify numerous other limitations regarding the types of assets that the CLO can hold.[61] For example, many agreements specify that only a certain percentage of the assets can come from a particular geographic region. Furthermore, other stipulations may limit the time-to-maturity of the assets, their interest rate characteristics, and the expected recovery rates for defaulted assets.[62]

In addition to diversification, CLO managers have relied upon advancements in credit risk modeling to decrease the theoretical risks of the portfolio.[63] The Gaussian copula model revolutionized risk assessment for CLOs.[64] David X. Li developed the model, and in March, 2000, *The Journal of Fixed Income* published Li's work.[65] Li studied the correlations between two assets and their associated risks of default.[66] His resulting model

58. *See* Markowitz, *supra* note 56. Harry Markowitz developed this theory in 1952; he won the 1990 Nobel Memorial Prize in Economic Sciences, in part based on his portfolio theory.

59. *Id.* at 89.

60. *See* Yago & McCarthy, *supra* note 27, at 26 (explaining that CLOs buy assets with different credit risk profiles, and then securitize the assets as bonds).

61. *See* Press Release, *Fitch Rates Blue Ridge CLO 2009-1 'AAA', Outlook Stable*, REUTERS (Apr. 29, 2009, 14:39 PM), http://www.reuters.com/article/2009/04/29/idUS223518+29-Apr-2009+BW20090429 (explaining that the transaction documents define the concentration limitations for the portfolio of bank loans).

62. FRB REPORT, *supra* note 47, at 47.

63. Mark Whitehouse, *How a Formula Ignited Market That Burned Some Big Investors*, WALL ST. J., Sept. 12, 2005.

64. *Id.*

65. David X. Li, *On Default Correlations: A Copula Function Approach*, 9 J. OF FIXED INCOME 8 (2000).

66. *See id.* at 21 (Li modeled the correlation between two assets by analyzing the change in prices for credit default swaps on one asset while a related asset was on the brink of default).

gave portfolio managers a tool by which they could assess the risks of default for each loan in a CLO pool.[67]

Armed with Li's Gaussian copula model, CLO market participants became more confident in their ability to accurately measure the risks of investing in a given CLO.[68] Moreover, CLO managers used this model and combined it with the fundamentals of portfolio diversification. These two factors gave investors confidence that CLOs were fundamentally sound and grounded in robust financial models.

2. Rating Agencies: How to Build "Investments" Out of "Junk"

Financial modeling gave the CLO market a boost in confidence, but another factor played a major role in the proliferation of CLOs. Many CLO bonds were highly rated by one or more of the three largest and most respected credit rating agencies.[69] Rating agencies have existed since 1909 when John Moody published ratings on railroad securities.[70] The Comptroller of the Currency ("OCC") solidified the importance of the rating agencies in 1936 when it issued regulations requiring banks to hold only investment-grade securities.[71] As a result, bond issuers needed ratings so that they could market their bonds to banks. In addition to the OCC regulations for banks, other agencies adopted similar ratings-based investment requirements for insurance companies, mutual funds, and pension funds.[72] Furthermore, in 1975, the Securities and Exchange Commission ("SEC") recognized Moody's, Standard & Poor's ("S&P"), and Fitch as Nationally Recognized Statistical Rating Organizations ("NRSROs").[73] Since then, issuers have relied upon the NRSROs to rate their debt offerings.

By 2006, the SEC recognized five NRSROs,[74] but only Moody's, Fitch, and S&P rated CLO bonds.[75] While investors typically used ratings

67. *See* Li, *supra* note 65.

68. Whitehouse, *supra* note 63.

69. Barnett-Hart, *supra* note 53, at 17.

70. Amy Borrus et al., *The Credit-Raters: How They Work and How They Might Work Better,* BUS. WEEK, Apr. 8, 2002, at 38 (S&P and Fitch soon followed Moody's).

71. Jerome S. Fons, *Tracing the Origins of "Investment Grade,"* MOODY'S INVESTORS SERVICE GLOBAL CREDIT RESEARCH 2 (Jan. 2004), http://www.moodys.com.br/brasil/pdf/InvGradeOrigins.pdf (explaining that the term "investment grade" originated from regulators and industry participant who were trying to distinguish between high quality and more speculative investment choices).

72. Borrus et al., *supra* note 70, at 38.

73. *Id.*

74. *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing before the Sen. Comm. On Banking, Housing, & Urban Affairs,* 110th Cong. (2007) (statement of Christopher Cox, Chairman, United States Securities and Exchange Commission).

75. U.S. SEC. & EXC. COMM'N, OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT

from NRSROs "as a starting point for classifying and understanding securities and their associated risks,"[76] some CLO investors may have used ratings as the cornerstone of their investment decisions.[77] Accordingly, when rating agencies assigned high ratings to CLO bonds,[78] investors assumed that such bonds entailed very low risk of default. Investors who had previously been skeptical of CLO bonds could now flock to them with the comfort that an NRSRO had utmost faith in the investments.

Ratings from NRSROs may have attracted CLO bond investors who would have otherwise chosen not to invest in such bonds. More importantly, however, high ratings from the NRSROs opened the doors to huge sums of capital from investors who did not have the choice to invest in CLO bonds, absent such ratings.[79] Many institutional investors, like pension funds, are generally prohibited from investing in instruments that are not investment-grade.[80] Each individual bank loan within a CLO pool might not carry an investment-grade rating. For example, Standard & Poor's rated the Tribune Company BB- in 2007, which is below investment-grade.[81] Accordingly, many institutional investors could not invest in the Tribune Company's syndicated bank loans.

Although low ratings prohibited many investors from buying Tribune Company loans outright, CLOs created a back-door through which institutional investors could gain exposure to lower rated and higher yielding loans, like those of the Tribune Company. This back-door exists because rating agencies often assign higher ratings to CLO bonds than to individual loans that are the underlying collateral for those bonds.[82] This phenomenon occurs because CLO bonds are backed by a diversified pool of bank loans.[83] Moreover, CLO bond issuers prioritize principal and interest pay-

---

CREDIT RATING AGENCIES 1 (July 2008) [hereinafter SEC REPORT ON CREDIT RATING AGENCIES]. The SEC investigated only the three rating agencies that were active in the CDO and RMBS markets.

76. Coval et al., *supra* note 49, at 5.

77. Dennis Vink & Frank J. Fabozzi, *Non-US Asset-Backed Securities: Spread Determinants and Over-Reliance on Credit Ratings* 4 (Yale International Center for Finance, Working Paper No. 09-13, 2009), (http://icfpub.som.yale.edu/system/fileuploads/2493/original/09-13.pdf?1265649569).

78. Moody's highest rating is "Aaa"; Standard & Poor's highest rating is "AAA"; Fitch's highest rating is "AAA." *See Investing in Bonds*, http://www.investinginbonds.com/learnmore.asp?catid=10&subcatid=68, (last visited Feb. 23, 2012).

79. Barnett-Hart, *supra* note 53, at 7.

80. Coval et al., *supra* note 49, at 2; *see also* Borrus et al., *supra* note 70, at 39 (explaining that investment grade bonds are those rated BBB or better).

81. Peggy Hwan & Emilie Courtney, *Tribune Co.'s $10.1B Secured Financing Rated BB-/Watch Negative (Recovery Rating: 2)*, STANDARD & POOR'S RATINGS DIRECT, (Apr. 19, 2007), http://dm.epiq11.com/onlinedocuments/trb/exhibits/npp%20exhibits/.%5CNPP0378.pdf.

82. *See* Vink & Fabozzi, *supra* note 77, at 6 (citing the example that while rating agencies downgraded corporate bonds for General Motors and Ford to junk status, they simultaneously upgraded some of the securitizations that owned those bonds).

83. Coval et al., *supra* note 49, at 8.

ments to bondholders based on the level of seniority or tranche of each bond.[84] By diversifying assets and prioritizing cash flows, CLO bond issuers created investments that appeared worthy of higher ratings than those of the individual loans in the collateral pool. Therefore, if an NRSRO assigned investment-grade ratings to CLO bonds, institutional investors were free to invest in such bonds, regardless of the "junk" —like the Tribune Company—was the foundation for those bonds.[85]

By the middle of 2007, the credit rating agencies had assigned their highest available ratings to over 37,000 structured finance products, worth about $5 trillion.[86] These staggering numbers represented 99 percent of the triple-A credit market, and created a false sense of security in the CLO bond market. [87] Investors relied upon the rating agencies to accurately measure and report the default probabilities and quality of CLO bonds.[88] In some extreme cases, investors may have used ratings in lieu of their own research and analysis.[89]

Prior to CLOs, most institutional investors could not invest in high yielding bank loans because such loans were not investment-grade assets.[90] With the help of advanced financial modeling and the rating agencies, however, CLO managers combined a diversified group of risky assets into one large pool. The diversified pool then became the collateral for investment-grade bonds in which large institutions could invest.[91] As a result, investors' demand for CLO bonds increased dramatically, and CLO issuers supplied these bonds in record numbers.[92]

---

84. *Id.*

85. *Id.* at 2; *see also* Chamblee & Tenholder, *supra* note 24, at 8 (explaining that "junk" is a description on any asset that is rated below investment-grade. While this line between junk and investment grade is slightly different depending on which rating agency is rating the asset, an asset rated BB- qualifies as "junk" by the standards of any of the rating agencies).

86. Saskia Scholtes & Richard Beales, *Top Rating Proving Crucial to Structured Finance Sector,* FIN. TIMES, May 17, 2007, http://www.ft.com/intl/cms/s/0/21e5032e-0413-11dc-a931-000b5df10621.html#axzz1d2OcsnGC. "Structured finance products" include collateralized loan obligations, collateralized bond obligations, collateralized debt obligations, syndicated loans, and other instruments.

87. *Id.*

88. Coval et al., *supra* note 49, at 3.

89. Vink & Fabozzi, *supra* note 77, at 4. Fabozzi and Vink conclude that investors probably did not base their decisions solely on ratings, but that they likely evaluated the reasoning behind the ratings in making investment decisions. Regardless, such investors would still be relying almost exclusively on the findings of the rating agencies. Moreover, Fabozzi and Vink's conclusions are based only on their study, which is not necessarily indicative how market participants behaved.

90. Borrus et al., *supra* note 70, at 38.

91. Barnett-Hart, *supra* note 53, at 7.

92. *See* Whitehouse, *supra* note 63. Li's model helped market participants calculate the default probabilities for the underlying collateral pool. It "fueled explosive growth" in the securitization market because investors are more likely to invest in products if they think that they can accurately model the

C. *Dodd-Frank's Risk Retention Regime*

On January 24, 2008, the chief economist for the National Association of Realtors reported that the United States was experiencing the worst housing market "in many, many years and possibly going back to the Great Depression."[93] The housing market collapse may have been the primary cause of the "Great Recession," but mortgage-backed CDOs were the fuel for the precipitous rise and fall of housing prices between 1998 and 2009.[94] Congress reacted to the severe economic problems by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act.[95] While preventing future housing market calamities may have been Congress' primary concern, the Dodd-Frank Act also addressed problems in the syndicated loan and CLO markets.[96]

The Dodd-Frank Act addresses numerous banking and securities laws, and it affects every financial institution in the United States.[97] Section 941(b) of the Dodd-Frank Act adds Section 15G to the Securities Exchange Act of 1934 ("Exchange Act").[98] This new provision of the Exchange Act requires federal banking agencies and the SEC to change the way in which issuers and investors manage asset-backed securities.[99]

Pursuant to Section 941's mandate, two of the banking agencies, the Federal Reserve Board and the Federal Deposit Insurance Corporation, proposed rules on credit risk retention ("Notice of Proposed Rules").[100] Subsequently, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development, signed on (all the signatories to the Notice of Proposed Rules are hereinafter referred to as the "Agencies") in support of the joint proposal.[101] Consistent with Section

---

risks of that investment. Prior to Li's model, CLO investors and issuers had limited tools for estimating the risks of CLO bonds.

93. Michael M. Grynbaum, *Home Prices Fell in '07 for the First Time in Decades*, N.Y. TIMES, Jan. 24, 2008, at 1.

94. *See* Notice of Proposed Rules, *supra* note 11, at 24095-24096.

95. Batty, *supra* note 46, at 13-14.

96. *See* Notice of Proposed Rules, *supra* note 11, at 24092 (introducing the proposed rules mandated by Section 941(b) of the Dodd-Frank Act; this Section addresses securitizations of all assets, not just assets related to the housing market).

97. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

98. 15 U.S.C. § 78o-11(b)(1) (as added by Dodd-Frank Act § 941(b)).

99. 15 U.S.C. § 78o-11(b)(1) (as added by Dodd-Frank Act § 941(b)).

100. Notice of Proposed Rules, *supra* note 11, at 24090.

101. *See id.* at 24090. While the FRB and the FDIC were the first Agencies to approve the Joint Rules, all the other Agencies approved the proposal shortly after; all six agencies authored the Notice of Proposed Rules.

941(b) of the Dodd-Frank Act, the proposed rules require securitizers to retain not less than five percent of the credit risk associated with any securitization transaction.[102] Section 941(a) of the Dodd-Frank Act defines a "securitizer" as either "an issuer of an asset-backed security; or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets."[103] Furthermore, the Notice of Proposed Rules summarizes a securitization transaction as "a transaction involving the offer and sale of ABS by an issuing entity."[104]

In the "General Definitions and Scope" section of the Notice of Proposed Rules, the Agencies lay out the different parties to a deal that could be required to retain the five percent credit risk.[105] The proposed rules provide that "a sponsor of a securitization transaction [must] retain the credit risk of the securitized assets."[106] The Agencies explain that this approach makes sense "in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized."[107] In Footnote 42 of the Notice of Proposed Rules, the Agencies further clarify that CLO managers fall squarely within this definition of sponsor: "the CLO manager generally acts as the sponsor by selecting the commercial loans . . . for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure."[108]

After the Agencies released the Notice of Proposed Rules, they requested public comments on the rules.[109] During the comment period, which ended August 1, 2011, various industry participants argued that CLOs comprised of syndicated bank loans should not be included in the risk retention requirements.[110] These opponents of the proposed rules claimed that Footnote 42 of the Notice of Proposed Rules exceeded the Agencies' rulemaking authority under the Dodd-Frank Act, and that it was contrary to the legislative intent of Section 941 of the Act.[111] Furthermore, the opponents argued that CLOs containing syndicated bank loans should be exempt from the risk retention rules because CLOs have performed well in the wake of the worst global economic conditions since the Great De-

102. *Id.* at 24099.

103. 15 U.S.C. § 78o-11(b) (as added by Dodd-Frank Act § 941(a)).

104. Notice of Proposed Rules, *supra* note 11, at 24098.

105. *Id.* at 24100.

106. *Id* at 24098.

107. *Id.*

108. *Id.* at 24098 n.42.

109. *Press Release*, U.S. SEC. & EXCH. COMM'N (June 7, 2011), http://www.sec.gov/news/press/2011/2011-121.htm.

110. *See* LSTA Comment Letter, *supra* note 11, at 2; *see also* HAHN ET AL., *supra* note 12, at 4.

111. LSTA Comment Letter, *supra* note 11, at 8.

pression.[112] Finally, they contended that requiring risk retention for CLO managers would hamper the CLO market, which would then cause a chain reaction resulting in harm to the U.S. economy.[113]

II. LEGISLATIVE INTENT AND THE AGENCY INTERPRETATION OF SECTION 941

CLOs should not be exempt from the Dodd-Frank Act's credit risk retention rules. Moreover, in most CLO transactions, the best candidate to retain that risk is the CLO manager. Footnote 42 of the Notice of Proposed Rules requires CLO managers to retain some of the credit risk in the underlying assets of a CLO pool.[114] This rule is consistent with both the plain language and the legislative intent of Section 941 of the Dodd-Frank Act.

Congress' broad goal of Section 941 was to "encourage sound lending practices, restore investor confidence, and permit securitization markets to resume their important role as sources of credit for households and businesses."[115] Risk retention addresses this goal by aligning the incentives of issuers, investors, and corporate borrowers. CLO managers should be subject to the Section 941 risk retention requirements. Exempting them from the rules would help to promote the "lack of discipline" that allowed securitization transactions "to harm investors, consumers, financial institutions, and the financial system."[116] Alternatively, where the legislative intent of Section 941 is unclear, the Agencies have the authority to interpret it in such a way that would apply the risk retention rules to CLO managers.

A. CLO Managers Fall Within the Plain Language of Section 941

Congress passed Section 941 of the Dodd-Frank Act to require securitizers to retain some of the credit risk of the loans that they securitize.[117] The legislative intent behind Section 941 is to require securitizers or sponsors of asset-backed securities to have "'skin in the game' [by] aligning their economic interests with those of investors in asset-backed securities."[118] CLO managers are both "sponsors" of asset-backed securities, and

112. *Id.* at 14.

113. *See* Batty, *supra* note 46, at 22–26 (hypothesizing that syndicated bank loans are vital to corporations; CLOs are vital to syndicated loans; regulation that restricts the CLO market will stifle corporate growth and ultimately inhibit the national economy).

114. Notice of Proposed Rules, *supra* note 11, at 24098 n.42.

115. S. REP. NO. 111-176, at 37 (2010).

116. Notice of Proposed Rules, *supra* note 11, at 24095.

117. *Id.* at 24095–24096.

118. S. REP. NO. 111-176, at 129 (2010).

they are "securitizers."[119] Accordingly, they fall within the plain language of the statute, and the Agencies should require CLO managers to retain credit risk. To understand why, it is imperative to look at the mechanics of a typical CLO transaction and to examine the statutory definitions of "sponsor" and "securitizer."

1. The Fundamentals of a CLO Securitization

In a typical syndicated bank loan CLO transaction, the manager initiates the securitization by partnering with an investment bank.[120] In some cases, the CLO manager is a subsidiary of, or has a significant relationship with the investment bank.[121] The investment bank provides financing for the manager to begin purchasing the syndicated bank loans that will eventually become the underlying collateral pool for the CLO bonds.[122] The manager continues to accumulate collateral, which it stores in an entity usually referred to as a "warehouse."[123] In the next phase of the transaction, the CLO manager sets up a bankruptcy-remote special purpose vehicle.[124] Ultimately, the special purpose vehicle buys the pool of bank loans from the warehouse; it then uses the asset pool as collateral to issue the CLO bonds to investors.[125]

The special purpose vehicle is necessary because it shields the CLO bondholders from any creditors of the manager or other institution who sells the collateral to the special purpose vehicle.[126] After the manager transfers the collateral pool, the assets are "'legally isolated' and consequently are no longer available to the seller or its creditors."[127] In other words, if the CLO manager becomes insolvent, its creditors have no claim to the assets that the manager transferred to the special purpose vehicle. Because the CLO manager is often a large asset manager or bank subsidiary like Credit Suisse Asset Management, ING Investment, or Golden Tree

119. Notice of Proposed Rules, *supra* note 11, at 24098.

120. FRB REPORT, *supra* note 47, at 22.

121. *Id.*

122. *See id.* (explaining that the investment bank provides the warehouse facility; the investment bank funds the warehouse with a line of credit, and the CLO manager uses these initial funds to purchase syndicated bank loans).

123. *See CDO Managers Win Back Warehouse Access*, SECURITIZATION.NET (June 8, 2007), http://www.securitization.net/article.asp?id=1&aid=7397 (discussing warehouses for CDOs, but the creation of a CLO is logistically the same as a CDO).

124. FRB REPORT, *supra* note 47, at 10.

125. *Id.*

126. *Special Purpose Entities (SPEs) and the Securitization Markets*, INT'L SWAPS & DERIVATIVES ASS'N 2 (Feb. 1, 2002), http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf.

127. *Id.*

Asset Management,[128] investors would be unlikely to buy CLO bonds absent the bankruptcy-remote special purpose vehicle structure.

2. CLO Managers Are "Securitizers" Under the Plain Language of the Dodd-Frank Act

Section 941(b) of the Dodd-Frank Act creates Section 15G of the Exchange Act. The new Section 15G(a)(3) defines the term "securitizer" as:

> (A) an issuer of an asset-backed security; or
>
> (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.[129]

The CLO manager is not the issuer of the asset-backed security; the special purpose vehicle is the issuer. Accordingly, the manager is not a securitizer under the Dodd-Frank Act's first definition of the term. In many cases, however, the CLO manager does fit into the second category of securitizers. In most, and "perhaps even the vast majority" of CLOs, the manager is responsible for organizing and initiating the transaction by transferring the CLO collateral to the special purpose vehicle.[130] In those cases, the CLO manager is a "securitizer" under Section 15G(a)(3), and thus subject to the statute's risk retention provisions.

While the CLO manager is usually the securitizer, in some transactions, other parties might qualify for that distinction. In "balance-sheet CLOs," for example, a bank that originated loans will transfer those assets from its balance sheet to a special purpose vehicle, which will ultimately become a CLO.[131] The purpose of a balance-sheet CLO is for the originating bank to transfer loans off its balance sheet so that it has the capital to originate new loans. For some balance-sheet CLOs, the originating bank will hire a third-party to be the CLO manager.[132] In such cases, the CLO manager would not be subject to Dodd-Frank's risk retention rules because it would not be the party "who organizes and initiates"[133] the transaction. Instead, the originating bank would be the securitizer, and thus responsible to retain not less than five percent of the credit risk.

---

128. *CLO Awards 2011*, CREDITFLUX (2011), http://media.cvc.com/lib/docs/155448-cloawards2011winnersfinalists.pdf.

129. 15 U.S.C. §780-11(b)(1) (as added by Dodd-Frank Act §941(b)).

130. *Overview of the Proposed Credit Risk Retention rules for Securitizations*, MAYER BROWN LLP 47–48 (Apr. 8, 2011) [hereinafter MAYER BROWN WHITE PAPER], http://www.mayerbrown.com/publications/article.asp?id=10782&nid=6.

131. Jobst, *supra* note 42, at 2.

132. MAYER BROWN WHITE PAPER, *supra* note 130, at 48.

133. 15 U.S.C. § 780-11(b) (as added by Dodd-Frank Act § 941(a)).

Like balance-sheet CLOs, in "reverse-inquiry CLOs," the manager is probably not the securitizer. A reverse-inquiry CLO exists where one or more investors initiate the transaction by specifying the types of bank loans in which they plan to invest.[134] The investors work with an asset manager to structure the transaction and to accumulate collateral that fits within their specified guidelines.[135] The manager is responsible for organizing and operating the collateral pool, but the investor is the chief architect of the transaction. In these transactions, the manager is more like an agent to the investor, rather than an independent third-party. For purposes of risk retention, the investor "organizes and initiates" the CLO by "indirectly"[136] transferring the assets of the collateral pool through the CLO manager. Accordingly, the manager would not be responsible for retaining the credit risk in a reverse-inquiry CLO.

Unlike balance-sheet and reverse-inquiry CLOs, the manager is the securitizer in most CLO transactions.[137] But, market participants argue that CLO managers should not be subject to the Dodd-Frank Act's risk retention rules. Contrary to the plain language of the new Section 15G(a)(3) of the Exchange Act, the Loan Syndication and Trading Association ("LSTA") contends that CLO managers are not securitizers under the statute.[138] In its comment letter in response to the Notice of Proposed Rules, the LSTA argued that "the manager does not organize and initiate" the ABS transaction by "directly or indirectly" selling or transferring any assets to the CLO.[139] While the LSTA provided no further detail in support of its assertion in the comment letter, its arguments rest on the assumption that in many CLO transactions the "warehouse" is the entity that transfers the assets to the special purpose vehicle.[140] Specifically, the LSTA argues that no transfer or sale of assets is necessary because the collateral warehouse simply evolves into the special purpose vehicle.[141] In most CLO transactions, however, the collateral manager initiates the warehouse, buys the collateral for deposit in the warehouse, and then structures a sale of the

134. MAYER BROWN WHITE PAPER, *supra* note 130, at 48.

135. *Id.*

136. 15 U.S.C. § 780-11(b) (as added by Dodd-Frank Act § 941(a)).

137. MAYER BROWN WHITE PAPER, *supra* note 130, at 47-48.

138. LSTA Comment Letter, *supra* note 11, at 9. The LSTA is a trade association that represents participants in the syndicated loan market.

139. *Id.*

140. Telephone Interview with Meredith Coffey, Executive Vice President, LSTA (Oct. 26, 2011).

141. *Id.*

collateral from the warehouse to the bankruptcy-remote special purpose vehicle.[142]

The warehouse and the special purpose vehicle are separate entities. If they were not, standard accounting rules would dictate that the transaction would not be a true sale, enabling the collateral pool and its subsequent bonds to be subject to the claims of the collateral manager's creditors.[143] In other words, if the LSTA was correct and the warehouse simply evolved into the special purpose vehicle, the structure would not be bankruptcy-remote, and investors would not be willing to buy its bonds. Therefore, the LSTA's legal argument is unworkable, and the CLO manager must be a "securitizer" under the plain language of Section 15G(a)(3) of the Exchange Act.

3. CLO Managers are also "Securitizers" Because They Are "Sponsors"

In addition to satisfying the definition of "securitizer" under the plain language of Section 15G(a)(3), CLO managers are also "sponsors" pursuant to SEC Regulation AB, as promulgated under the Exchange Act.[144] The Notice of Proposed Rules uses the term "sponsor" interchangeably with the statute's second definition of "securitizer."[145] The Agencies explain that the entity who "organizes and initiates the asset-backed securities transaction by selling or transferring assets" is "substantially identical" [146] to the definition of "sponsor" in Regulation AB.[147]

The Dodd-Frank Acts defines "securitizer" by adopting Regulation AB's definition of "sponsor." Therefore, it is logical that Congress intended to also rely upon the SEC's explanatory comments regarding the definition of "sponsor." In Section 4.01 of the SEC's *Manual of Publicly Available Telephone Interpretations*, the SEC Division of Corporation Finance explains that "[w]hether a party is considered a 'sponsor' involves a facts and circumstances analysis of whether its actions bring it within the definition of Item 1101(l) of Regulation AB."[148] This interpretation of the definition suggests that the statutory language is not all-inclusive. Instead, an entity might be construed as a sponsor of an asset-backed security based

142. *See* MAYER BROWN WHITE PAPER, *supra* note 130, at 47–48. The CLO manager is the "sponsor" because "no other party transfers the collateral."

143. Tarun Sabarwal, *Common Structures of Asset-Backed Securities and Their Risks* 4 CORPORATE OWNERSHIP & CONTROL 258, 262 (Fall 2006).

144. 17 C.F.R. § 229.1101 (2011).

145. Notice of Proposed Rules, *supra* note 11, at 24098.

146. *Id.*

147. *Id.*

148. *Manual of Publicly Available Telephone Interpretations*, SEC. & EXCH. COMM'N DIV. OF CORP. FIN. 2, http://www.sec.gov/interps/telephone/cftelinterps_regab.pdf (last visited Mar. 24, 2012).

on the totality of the circumstances surrounding the transaction. Moreover, in its submission of the final rule and request for comment on Regulation AB, the SEC further elaborated on the definition of "sponsor."[149] The SEC clarified that even where the collateral assets pass through multiple parties before arriving in the special purpose vehicle, "it will be clear in nearly all instances as to which party was in the position of organizing and initiating the securitization transaction and thus is the sponsor."[150]

The SEC's various comments on the meaning of the word "sponsor" convey the impression that the regulator is concerned more with substance than with form. Specifically, regardless of the complexity or number of parties to an asset-backed securities transaction, the "sponsor" is the party who organizes and initiates the transaction.[151] Accordingly, for the purposes of the Dodd-Frank Act, Congress' reliance upon the SEC's definition of "sponsor" conveys Congress' belief that the CLO manager—the party usually responsible for organizing and initiating the CLO—is a "securitizer."

Thus, CLO managers are "securitizers" both under the plain language of the Dodd-Frank Act and under the SEC's definition of "sponsor" in Regulation AB. Moreover, the fundamental structure of CLOs requires someone to organize and initiate the transaction and to transfer the pool of syndicated bank loans to a special purpose vehicle. In the "vast majority" of CLOs, that someone is the CLO manager.[152] Therefore, the Dodd-Frank Act requires the CLO manager to retain "not less than 5% of the risk associated with [the] securitization transaction."[153]

B. The Agency Interpretation of the Statute Carries the Day

Even if the plain language of the new Section 15G of the Exchange Act was ambiguous, the Agencies' interpretation would prevail. Citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, the LSTA argues that the Agencies' proposed rules exceed their rulemaking authority.[154] While *Chevron* covers only final agency rules, not proposals, challenging the Agencies' proposed rules under its holding would be unsuccessful even if *Chevron* did apply. Moreover, if the Agencies adopt the proposed rules subjecting CLO managers to risk retention, as this note advocates, the Court's holding in *Chevron* will support the Agencies' inter-

149. Asset-Backed Securities, Fed. Reg. 70-1506, 1534 (Jan. 7, 2005) (to be codified at 17 C.F.R. pts. 229, 239).

150. *Id.*

151. *See id.*

152. MAYER BROWN WHITE PAPER, *supra* note 130, at 47-48.

153. 15 U.S.C. § 780-11(b)(1) (as added by Dodd-Frank Act § 941(b)).

154. LSTA Comment Letter, *supra* note 11, at 8.

pretation of the term "securitizer" under Section 15G of the Securities Exchange Act.

Under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, courts must give "deference to administrative interpretations" of the statute at issue.[155] In *Chevron*, the Supreme Court held that where a statute is ambiguous, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer."[156] In addition, the Court explained that when Congress leaves gaps in a statute for an agency to fill, the resulting rules "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[157]

In the case of Section 15G of the Securities Exchange Act, Congress' intent is clear: "the Federal banking agencies and the [Securities and Exchange] Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk." Accordingly, the Agencies' proposed rules[158] carry out Congress' intent by requiring securitizers, including CLO managers, to retain risk. Applying *Chevron*, "that is the end of the matter."[159]

Assuming *arguendo* that the statutory definition of "securitizer" is unclear, the Agencies' interpretation of that term is controlling as long as it is "based on a permissible construction of the statute."[160] The Agencies' definition of the words "securitizer" and "sponsor" is neither "arbitrary" nor "capricious" because the Agencies merely interpreted Section 15G of the Exchange Act by referring to the definition of the word "sponsor" in Regulation AB of the Act. Moreover, applying the term "securitizer" to CLO managers is not "manifestly contrary to the statute" because Congress intended to impose risk retention provisions on "those who issue, organize, or initiate asset-backed securities."[161] While CLO managers do not issue the asset-backed securities (the special purpose vehicle is the issuer),[162] they unquestionably organize and initiate them.

CLO managers fit squarely within Congress' definition of the word "securitizer" in Section 15G of the Exchange Act. Even if Congress' intent is not clear, the Court's holding in *Chevron* gives the Agencies latitude to

155. 467 U.S. 837, 842–844 (1984).
156. *Id.* at 844.
157. *Id.*
158. *See generally* Notice of Proposed Rules, *supra* note 11.
159. *Chevron*, 467 U.S. 837 at 842.
160. *Id.* at 843.
161. S. REP. NO. 111-176, at 128 (2010).
162. FRB REPORT, *supra* note 47, at 10.

interpret and apply the term "securitizer" in any way that is consistent with reasonable statutory construction.[163] In Footnote 42 of the Notice of Proposed Rules, the Agencies explained that CLO managers are securitizers.[164] The Agencies' interpretation is consistent with Congressional intent and the plain language of Section 15G; both suggest that CLO managers should be subject to the Dodd-Frank Act's risk retention rules.

III. CREDIT RISK RETENTION FOR SYNDICATED BANK LOAN CLOS IS PRUDENT POLICY

In addition to the persuasive legal reasoning discussed above, prudent public policy also favors credit risk retention for CLO managers. While CLOs outperformed other securitization transactions during the past several years,[165] their risks are similar to those of the products that helped cause the ongoing economic downturn. Moreover, risk retention is an appropriate tool to mitigate the risks of CLOs becoming a catalyst for the next economic meltdown. Finally, the Agencies' proposed risk retention rules will not stifle economic recovery.

A. CLOs Are Susceptible to the Same Risks as Other Securitized Products

CLOs should be subject to the Dodd-Frank Act's risk retention provisions because they have structural flaws that pose risks to the national economy. According to the LSTA, "Open Market CLOs did not have a part in causing the financial meltdown of 2008."[166] By contrast to CDOs consisting of subprime residential mortgages, CLOs were admittedly not as instrumental in causing the financial crisis. However, the tremendous growth of the CLO market between 1997 and 2007[167] was symptomatic of the loose lending standards that undoubtedly contributed to the financial disorder beginning in the summer of 2007. More importantly, even if CLOs were not a direct cause of the most recent financial crisis, credit risk retention will help ensure that they do not trigger a future financial meltdown.

Despite outperforming other securitized products like commercial and residential mortgage-backed CDOs, the CLO market has, nonetheless, ex-

163. *Chevron*, 467 U.S. 837 at 843-44.

164. Notice of Proposed Rules, *supra* note 11, at 24098 n.42.

165. *The Impact of Risk Retention on CLOs and Other Means of Aligning Incentives*, THE LOAN SYNDICATION & TRADING ASS'N 2 (2011), http://www.lsta.org/WorkArea/showcontent.aspx?id=11904.

166. LSTA Comment Letter, *supra* note 11, at 3. The LSTA refers to CLOs that hold syndicated bank loans as "Open Market CLOs" because syndicated bank loans are widely traded in the open secondary market.

167. LSTA White Paper, *supra* note 52.

perienced widespread problems since 2008.[168] Between December 2008 and December 2009, the rating agencies downgraded sixty-five percent of the CLO bonds that they had originally rated triple-A.[169] Likewise, rating agencies downgraded eighty-four percent of double-A rated CLO bonds, and almost one hundred percent of the bonds rated lower than double-A.[170] Furthermore, the default rate for syndicated bank loans soared from less than two percent in 2007 to almost ten percent in 2009.[171]

While only six of approximately six hundred CLOs experienced events of default since 2008,[172] CLOs have inherent structural weaknesses that could ultimately lead to economic calamity. Most notably, CLOs take advantage of the same ratings inefficiencies that allowed the subprime residential mortgage-backed CDO market to expand and to ultimately destabilize the national economy. Moreover, the incentives of the CLO manager are not always aligned with those of the investors.

1. CLOs Exploit a Broken Ratings System

One of the primary reasons why CLO bonds attracted so much capital in recent years is that they offer investors high ratings and attractive returns. The high ratings are, however, concerning for two main reasons. First, rating CLO bonds is a very complex undertaking, and rating agencies used flawed models to accomplish this task.[173] Furthermore, the ratings process is rife with conflicts of interest. The securitization market should not rely upon flawed rating systems. Instead, the foundation of this market should be engaged investment managers making prudent decisions that ultimately affect their own capital; requiring these managers to retain credit risk achieves this goal.

i. (Junk + Junk) x (Pooling + Tranching) = AAA?

Part one of this note explored how rating agencies assign "investment-grade" ratings to CLO bonds because of both their tranche structures and their diversified underlying collateral pools.[174] In the typical CLO, for example, the manager constructs the underlying collateral by purchasing 150-

168. *See* FRB REPORT, *supra* note 47, at 62–63.

169. *Id.* at 62.

170. *Id.*

171. A SYNOPSIS OF THE BANK LOAN MARKET, HOTCHKIS & WILEY CAPITAL MANAGEMENT Chart 5 (2011), http://www.hwcm.com/assets/documents/Marketing-Pieces/Newsletters/Synopsis-of-the-Bank-Loan-Market-HW-High-Yield-2Q11-Newsletter.pdf.

172. LSTA Comment Letter, *supra* note 11, at 7.

173. Coval et al., *supra* note 49, at 6.

174. Coval et al., *supra* note 49, at 8.

250 different syndicated bank loans.[175] Each loan by itself may not be an investment-grade asset, but the manager spreads the risk of default by purchasing loans from different economic sectors and from different geographical regions.[176] Although this approach to portfolio management is grounded in sound investment fundamentals,[177] rating agencies had minimal experience in analyzing default probabilities for these pools of assets and their ensuing CLO bonds.[178]

For over a century, investors have relied upon the ratings agencies' acumen in analyzing individual debt instruments.[179] Rating an individual loan involves assessing the borrower's expected cash flows and the likelihood of default.[180] By contrast, rating a pool of over two hundred bank loans is "far more complicated."[181] The primary obstacle to rating large pools of loans is that analysts must make assumptions regarding the correlations between the different assets in the pool.[182] In other words, the rating agency must first assign the probability of default for each individual loan in the collateral pool. The agency must then try to figure out the probabilities of multiple borrowers defaulting in tandem, also known as default correlation.[183] Because of the complexities of rating CLOs, the rating agencies relied upon new financial formulas, such as David X. Li's Gaussian copula model.[184]

In addition to the difficulties of rating a diversified pool of assets, the rating agencies overestimated the benefits of the tiered or tranched CLO structure. Agencies rate each class or tranche of bonds based on its level of seniority and associated claim to the principal and interest payments of the underlying collateral.[185] CLO bonds that have the highest priority claim to the principal and interest payments are perceived as the least risky class, thereby receiving the highest ratings.[186] By contrast to the AAA- rated bonds with the first claim to payments, the bonds that are lower in priority

175. LSTA White Paper, *supra* note 52, at 6.

176. Jennifer Banzaca, *Collateralized Loan Obligations,* 3 THE HEDGE FUND L. REPORT 1, 1 (Apr. 2, 2010), http://www.blankrome.com/siteFiles/CollateralizedLoanObligations.pdf.

177. Markowitz, *supra* note 56, at 89.

178. Coval et al., *supra* note 49, at 3–4, 8 (explaining that rating agencies have almost a century of experience in rating single issues, but they have relatively little experience—one decade's worth—in rating securitized pools of assets).

179. *Id.* at 4, 8.

180. *Id.* at 3.

181. *Id.*

182. *Id.*

183. *Id.*

184. *See id.* Rating agencies used the Gaussian copula to estimate default correlations.

185. *Id.*

186. *See* Sabarwal, *supra* note 143, at 163.

receive lower ratings.[187] In other words, "senior tranches only absorb losses after the junior claims have been exhausted, allowing [the senior bonds] to obtain credit ratings in excess of the average rating on the collateral pool."[188]

While this tiered ratings system seems like a logical scheme to lower the risk of the senior tranches of bonds, it does not account for the possibility that many of the underlying syndicated bank loan borrowers could all at once stop making principal and interest payments.[189] For example, when the housing market slumped in 2007, the economy began contracting and credit markets seized in 2008.[190] Businesses struggled to earn profits and even stay solvent. Against this backdrop, the Tribune Company defaulted on more than $10 billion worth of syndicated bank loans.[191] But, the economic damage was not isolated to one aggressive financier's buyout of a declining media company; Tribune's default was merely a symptom of a much larger problem. The fallout was also not contained to one business sector or one geographic region.[192] Rather, wide swaths of corporate borrowers from all industries and geographical locations could not make scheduled principal and interest payments on their syndicated bank loans.[193] As a result, the lowest rated CLO tranches "were wiped out and CLO senior notes were revealed as significantly riskier" than their accompanying interest rates and ratings suggested.[194]

ii. Rating Agencies Cannot Bite the Hand that Feeds Them

In addition to the sheer difficulty of rating CLO bonds, the ratings process is fraught with conflicts of interest.[195] Foremost among these is the "issuer pays" conflict.[196] This conflict exists because the CLO issuer is responsible for requesting and paying the agencies to rate the CLO's bonds.[197] Therefore, the rating agency has an incentive to rate the bonds favorably so that the issuer will reward the agency with future ratings requests.[198] Furthermore, in many cases, the ratings agencies have little or no

187. *Id.*
188. Coval, *supra* note 49, at 9.
189. Banzaca, *supra* note 176, at 1.
190. *Id.*
191. Ou & Emery, *supra* note 9, at 2.
192. Banzaca, *supra* note 176, at 1.
193. Ou & Emery, *supra* note 9, at 1.
194. Banzaca, *supra* note 176, at 1.
195. Jeffrey A. Barrack, *SEC:Rating Agencies Suffer From Conflicts of Interest*, THE LEGAL INTELLIGENCER, (Aug. 27, 2008), http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202424079090.
196. SEC Report on Credit Rating Agencies, *supra* note 75, at 23.
197. *Id.*
198. *Id.*

separation between the analysts responsible for assigning the ratings and the employees responsible for negotiating fees.[199] In its *Report on Credit Ratings*, the Securities and Exchange Commission cited one example in which "senior analytical managers" could also "participate directly in fee discussions with issuers."[200] Finally, the "issuer pays" model encourages the issuer to "shop" amongst the ratings agencies to see which agency will assign the highest ratings to its CLO bonds.[201]

Market participants overestimated rating agencies' ability to analyze multiple tranches of bonds that are collateralized by hundreds of diversified bank loans. In addition, ratings agencies may have skewed their analyses towards favorable ratings because of inefficiencies like the "issuer pays" conflict. CLO managers took advantage of the inflated ratings on their bonds by marketing them to institutional investors who could not have invested but for the investment-grade ratings. Effectively, institutional investors flooded corporate borrowers with inexpensive capital to which they would not have otherwise had access.

Subsection C of Title IX of the Dodd-Frank Act addresses some of the most problematic deficiencies in the ratings process.[202] But, Subsection C will do nothing to alleviate the dependence on ratings. A fundamental flaw of CLOs, and more generally, all securitized products, is their over-reliance on asset ratings. For example, ratings agencies have the power to determine which investors can buy certain assets. Where the agencies assign ratings that are not "investment-grade," most institutional investors cannot purchase that particular asset.[203] Also, the asset's rating determines its pricing; investors require higher rates of return for taking the risks associated with lower-rated assets. Effectively, without ratings, the securitization market could not function.

While ratings can be a valuable tool, they should not be the foundation of a $13 trillion global market.[204] The Dodd-Frank Act's risk retention

199. *Id.* at 24.

200. *Id.*

201. Stuart Gittleman, *U.S. Senator Urges Scrapping 'Fundamentally Flawed' Issuer-Pay Credit-Rating Model,* THOMSON REUTERS ACCELUS, (Sept. 2, 2011), http://www.complinet.com/dodd-frank/news/articles/article/us-senator-urges-scrapping-fundamentally-flawed-issuer-pay-credit-rating-model.html (quoting Senator Franken).

202. 15 U.S.C. § 78o-7 (as amended by Dodd-Frank Act §932).

203. Borrus et al., *supra* note 70, at 39.

204. *See* ASSOCIATION FOR FINANCIAL MARKETS IN EUROPE, Figure 2.3 (2011), http://www.sifma.org/uploadedfiles/research/reports/2011/europe-securitisation/europe-securitisation-quarterly-2011-08-24-afme-sifma.pdf. As of the end of 2010, the total outstanding balance for securitizations in Europe was EUR 2,092.6, and the total outstanding in the U.S. was EUR 7,839.9; converting EUR to USD at the 2010 year-end exchange rate of $1.33/1 EUR yields a total securitization market size of $13.2 trillion.

requirements can alleviate some of the reliance on the ratings system. In CLOs, for example, managers who retain credit risk will rely more upon their own due diligence and less upon ratings. Moreover, if CLO managers retain credit risk, they will not organize and initiate transactions that are based on non-transparent and faulty ratings assumptions.

2. Credit Risk Retention Aligns Incentives

In addition to exploiting a faulty ratings system, CLO managers do not always have the same interests as their investors. If CLO managers retain credit risk, their incentives will be aligned with investors who buy their bonds. CLO bond investors, especially institutions, want stable returns and limited volatility over the life of their investment. By contrast, CLO managers can be lured by short-term gains that come from investing in riskier assets. Furthermore, managers are compensated regardless of the performance of the underlying loan pool.[205]

While CLO managers usually earn their compensation through a multi-part fee structure,[206] this does not incentivize the manager in the same way as risk retention would. Typically, the manager earns a base fee that is senior to all of the claims of the bondholders.[207]The base fee is usually between ten and twenty basis points per annum, multiplied by the outstanding principal balance of the collateral pool.[208] Therefore, the larger the collateral pool, the larger the manager's base fee. Moreover, if the manager buys lower quality assets at a discount, the base fee is not diminished. Thereby, the manager has an incentive to buy lower quality assets that are trading below their par value; the base fee rewards quantity over quality. This fee is similar to a base fee that typical hedge fund managers, or even mutual fund managers, earn on their assets under management. Unlike mutual fund or hedge fund investors, however, investors in CLO bonds usually cannot withdraw their investment if they are unhappy with the CLO manager's performance. The only timely way that CLO bondholders can recover their investments is to sell their interest to other investors.[209]

---

205. LSTA Comment Letter, *supra* note 11, at 6 (explaining that CLO managers earn a base fee that has priority over interest payments to bondholders; regardless of whether the bondholders get their interest payment, the CLO manager earns the base fee).

206. FRB REPORT, *supra* note 47, at 46–47.

207. *Id.*

208. LSTA Comment Letter, *supra* note 11, at 6.

209. FABOZZI ET AL., *supra* note 17, at 47 Unlike hedge funds and mutual funds that can theoretically exist in perpetuity, CLOs have definitive start dates and maturity dates. CLO bondholders receive periodic interest and principal payments throughout the life of the CLO, and they receive the remainder of their principal at maturity.

In addition to the base fee, the manager can earn fees that are subordinate to the claims of the noteholders, but senior to the equity holders.[210] These subordinated fees are usually between thirty and forty basis points of the outstanding principal balance of the collateral pool.[211] Like the base fee, the subordinated fee incentivizes the CLO manager to buy quantity over quality. Although the manager only receives the subordinated fee after all bond investors receive their interest payments, the manager can manipulate the loan portfolio to achieve large short-term gains at the expense of longer-term performance. For example, the CLO manager could load the portfolio with loans that pay monthly interest, but only pay principal at maturity. While interest-only loans are riskier investments, this scheme would help ensure that the manger would receive at least some subordinated fees.

CLO management fee structures do not adequately align the interests of the CLO manger and the bond investors. By contrast, the Dodd-Frank Act's credit risk retention provisions give managers strong incentives to make prudent investment decisions on behalf of themselves and their investors. Where CLO managers "retain a material amount of risk," they have "skin in the game" and their economic interests are aligned with those of investors.[212]

B. Risk Retention for CLOs Will Not Stifle the National Economy

Risk retention is an effective means of improving the structural inefficiencies of CLOs. In addition, imposing risk retention requirements on CLO managers will not harm the national economy. Risk retention will not cause the CLO market to become extinct by forcing CLO managers to invest money that they do not have. Furthermore, while CLOs provide an abundance of capital to the syndicated bank loan market, other lenders can fill any voids in their absence.

1. Risk Retention Will Not Destroy CLO Managers

Critics of Section 941 of the Dodd-Frank Act argue that CLO managers do not have the resources to hold a five percent stake in either the underlying loan pool or the CLO bonds.[213] In a survey conducted by the LSTA, eighty-seven percent of the surveyed CLO managers reported that they did not have the capital to meet the five percent risk retention thresh-

210. FRB REPORT, *supra* note 47, at 47.
211. LSTA Comment Letter, *supra* note 11, at 7.
212. S. REP. NO. 111-176, at 129 (2010).
213. *The Impact of Risk Retention on CLOs*, *supra* note 165, at 2-3.

old.[214] Ironically, however, the LSTA also argues that CLO managers should not be subject to risk retention because they already hold some of the CLOs equity.[215] Presumably, the LSTA is arguing that CLO managers can afford to hold some credit risk, but they cannot afford to hold the five percent that Section 941 mandates.

The LSTA also argues that "CLO managers are simply asset managers; they are not themselves sources of capital."[216] This argument suggests that CLO managers are akin to mutual fund managers. As this note explained earlier, however, CLO bondholders cannot exit their investment on demand in the same way that a mutual fund investor can. Accordingly, regulators must hold CLO managers to more stringent standards. Furthermore, if the existing CLO managers do not have enough capital to retain risk, various large hedge funds "have the personnel and infrastructure in place to manage CLOs today or with minor adjustments."[217] Regardless of whether CLO managers have the capital to retain five percent of the CLO's credit risk, they will either have to adjust their business models accordingly or exit the CLO management business.

2. Risk Retention Will Not Choke the Syndicated Bank Loan Market

Even if CLOs cease to exist, that would not signal the end of the syndicated bank loan market. Touting the merits of syndicated bank loans, the LSTA noted, "[t]he loan market itself is more transparent than the markets for many other types of assets."[218] Assuming that syndicated bank loans are "priced and structured in an attractive way,"[219] borrowers should have no trouble attracting investors outside of the CLO market. For example, BlackRock Inc., "the world's largest asset manager," recently opined that insurers such as Aflac Inc. and Everest Re Group Ltd. are ready to invest

214. *See id.* "[O]nly 13% of respondents (by count) said that they could retain 5% risk in a vertical pro rata strip." A vertical pro rata strip is one of the permissible methods of credit risk retention under the proposed rules. This method of risk retention requires the collateral manager to hold 5% of each class of CLO bonds. While the vertical strip is only one of five methods of risk retention that the Proposed Rules allow, it would likely be a popular choice because it would be the simplest form for securitizers to implement.

According to the LSTA sample of collateral managers, only 13% said they had the capital to retain 5% of the credit risk. On the other hand, "87% of the CLO managers said they could retain some amount of equity/first loss position.

215. *Id.* at 4 The LSTA reports that "CLO managers contributed average equity of roughly 1.7% of the face value of their CLOs."

216. LSTA Comment Letter, *supra* note 11, at 15.

217. Banzaca, supra note 176, at 1.

218. LSTA Comment Letter, *supra* note 11, at 5.

219. *Id.*

billions of dollars in syndicated bank loans.[220] Moreover, syndicated bank loans existed long before CLOs became their dominant sources of capital.[221]

The Dodd-Frank Act's credit risk retention requirements will not stifle economic growth. A robust capital market will always exist for "blue-chip companies like IBM" and smaller growth-oriented companies like Sizzling Platter.[222] If CLOs are structurally sound and transparent, they will continue to attract quality managers, regardless of risk retention requirements. On the other hand, if CLOs are merely a mechanism of turning junk-rated leveraged loans into investment-grade bonds, then it is imperative that securitizers have "skin in the game."

CONCLUSION

More than three years after the Tribune Company went bankrupt, CLOs that owned its syndicated loans still do not have a resolution to their claims.[223] While CLOs may be an important source of capital to the syndicated bank loan market, they can also lead to irresponsible lending practices. The Dodd-Frank Act's risk retention requirement is a sound method of ensuring that CLO managers do not stray too far from practical investment principles. Moreover, the regulatory Agencies' proposed rules are a sensible approach to implementing risk retention. How many CLO managers would have bought Tribune Company syndicated loans if they had been required to retain a portion of those loans on their own books? The national economy cannot withstand another credit crisis fueled by opaque and unregulated financial instruments.

220. Noah Buhayer & Richard Bravo, *BlackRock Says Insurers May Be 'Next Phase' of Loan Capital*, BLOOMBERG BUSINESSWEEK (Sept. 28, 2011), http://www.businessweek.com/news/2011-09-28/blackrock-says-insurers-may-be-next-phase-of-loan-capital.html.

221. *Compare* Yago & McCarthy, *supra* note 27, at 3 (showing the growth and development of the syndicated loan market from 1987 to 2004), *with* ZANDI, *supra* note 55 (explaining that CLOs became prevalent in the early 2000s, "in the wake of the tech-stock bust").

222. LSTA Comment Letter, *supra* note 11, at 4.

223. Michael Oneal, *New Twist in Tribune Co. Bankruptcy Case Could Benefit Billionaire Sam Zell*, CHI. TRIB. (Nov. 7, 2011).